COMMONWEALTH OF MASSACHUSETTS
BEFORE THE
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request for Comments on the Procurement of Default Service Power Supply for Residential and Small Commercial and Industrial Customers.	)	D.T.E. 04-115

INITIAL COMMENTS OF
WESTERN MASSACHUSETTS ELECTRIC COMPANY

EXECUTIVE SUMMARY

The current default service procurement practices are working reasonably well. Solicitations have been sufficiently robust and smaller customers are receiving a competitively-bid price for their electricity. At the same time, solicitations every six-months for the procurement of fifty percent of smaller customers' default service load for a twelve-month period protect customers from excessive price volatility. Given the Department of Telecommunications and Energy's ("Department") clearly enunciated goals of reflecting market prices in default service charges and maintaining a level of price stability, the current policy achieves an appropriate balance.

Western Massachusetts Electric Company ("WMECO" or the "Company") does not recommend any significant changes to default service procurement solicitation periods at this time. WMECO recognizes that soliciting power for a longer period would lead to additional price stability. However, it may also lead to higher overall costs to consumers. This is particularly true in the current wholesale energy market environment, an environment in which the number of important unresolved issues may lead providers to add substantial risk premiums as the supply period lengthens. WMECO does not believe that default service solicitations for smaller customers need be any more frequent than every six months.

WMECO's counsel against any major changes applies equally to statewide solicitations and statewide auctions. While on the surface there is a certain allure to statewide procurement, it is not clear that there are any advantages, and there appear to be several disadvantages. One disadvantage is that default service would have to be procured separately for each distribution company due to differences in the cost to serve different distribution companies. In addition, statewide efforts appear to impose additional costs, lead to the unnecessary duplication of functions, and raise issues involving standardization of contract terms and contract credit. WMECO does not believe that the experience of Maine with a statewide solicitation and New Jersey with an auction warrants either of those practices in the Commonwealth.

The Commonwealth currently employs a time-tested reasonable approach for the procurement of default service. It is reasonable to monitor the approach to determine if changes are warranted. However, WMECO believes that the Department struck the right balance in D.T.E. 02-40-B, and nothing has occurred in the interim to require changes in the process now.

I. INTRODUCTION

WMECO appreciates the opportunity to provide further comments to the Department on the procurement of default service power supply for residential and small commercial and industrial customers. As the Department has noted in its December 6, 2004 Request for Comments ("Request for Comments"), the Department previously established default service pricing and supply procurement policies in D.T.E. 02-40-B (April 24, 2003) after a comprehensive investigation.

The Department's Request for Comments comes at the end of the statutorily-established seven-year transition period under the Electric Utility Restructuring Act of 1997 ("Act") (G.L. c. 164, § 1B(b)). As of March 1, 2005, customers on standard offer service will take service from WMECO and other distribution companies under default service. G.L. c. 164, §1B(d). In its Request for Comments, the Department has noted that the competitive retail market for low-use, low-load-factor customers has lagged and that with the end of the transition period it is prudent to review default service procurement policies to ensure those policies are not inhibiting the competitive market (p. 2).

As discussed more fully below, WMECO believes that the current default service procurement practices are working reasonably well. Solicitations have been robust and smaller customers are receiving a competitively-bid price for their energy while being protected from excessive price volatility. WMECO does not believe that the reason the competitive market has lagged in enrolling smaller customers is due to the default service procurement practices, and does not believe that any major changes to the current practices are needed or warranted.

II. CURRENT PROCUREMENT RULES ARE WORKING

The framework for the procurement of default service is set forth in the Act. The Act states that distribution companies will procure default service through "competitive bidding" at rates that shall not "exceed the average monthly market price of electricity" and for a term that remains “uniform for periods of up to six months. G.L. c. 164, § 1B(d).

In D.T.E. 02-40-B, the Department established important principles for the design and implementation of default service. The Department stated that default service should be provided in a manner compatible with an efficient market structure and that “for those customer classes for whom an efficient retail competitive market may not be available, default prices should be provided in a manner that ensures the electric service will be available at a reasonable price” (D.T.E. 02-40-B, p. 30). The Department has also stated that the most important goal is to provide for fair procurement rules, not force a particular outcome. Thus, the Department stated that “[i]f consumer welfare is maximized with very few customers switching to competitive suppliers, it is not a policy failure, as long as there is free choice and there are no artificial impediments for either suppliers or consumers. *Id.*, p. 6.

In D.T.E. 02-40-B, the Department examined a number of the detailed questions it is revisiting in this proceeding. WMECO believes it is instructive to quote at length from the conclusions set forth in the Department’s April 24, 2003 order with respect to default service procurement for smaller customers. The Department found:

> Unlike the market that has developed for medium and large C&I customers, the competitive options available for residential and small C&I customers are limited. As such, the pricing and procurement strategy for smaller customers must ensure the availability of electric service at reasonable and stable prices.
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> With respect to the default service pricing options available to smaller customers, eliminating the fixed, six-month option would be inconsistent with these customers’ wishes for price stability. On the other hand, setting the fixed pricing option to a longer term could be inconsistent with the Department’s objective of keeping default service prices at market-based levels. There is a balance to be struck between

> providing sufficient price certainty as well as efficient price signals. Based on the comments received, the Department believes that the current fixed, six-month option is the appropriate balance for current and foreseeable market conditions for these customers.
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> With respect to procurement, shortening the procurement term would ensure that default service prices would more accurately reflect market prices. However, a shortened term would increase the volatility of default service prices. Conversely, lengthening the procurement term would provide for more price stability, but would weaken the connection to market prices. While a staggered solicitation approach may improve the current procurement strategy, the DOER's proposal is too complex and would be overly burdensome to implement. For these reasons, we are not convinced that DOER's proposal would provide its intended benefits.
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> The Department sees merit, however, in revising the current practice in which each distribution company procures 100 percent of its default service supply every six months. Because prices in the wholesale market can change quickly, procuring 100 percent of supply at intervals of six-months contracts could result in prices that represent an anomalous market condition. NSTAR's suggestion to procure 50 percent of its default service supply semi-annually, for twelve-month terms, strikes a better balance between price certainty and price efficiency than does the current approach. Therefore, the Department directs each distribution company to implement such a procurement strategy at the time of their next default service supply solicitation [pp. 44-45].

WMECO recognizes the need to reexamine the effectiveness of the policies implemented in D.T.E. 02-40-B with the experience gained in the interim period. However, the Department's conclusions in D.T.E. 02-40-B were arrived at after a comprehensive and balanced review of the numerous considerations raised. The balance the Department struck in D.T.E. 02-40-B made a good deal of sense 20 months ago and WMECO's experience since April 2003 does not suggest changes are necessary. Looking forward, there is nothing relating to the end of the restructuring transition period that would argue for significant changes in the procurement of default service for smaller customers.

On the contrary, external factors strongly argue for keeping in place the current default service procurement system. The external factors are wholesale market rule uncertainty and market volatility. With respect to market rule uncertainty, it may be the case that the Commonwealth's restructuring transition period is coming to an end, but that does not mean that market rules and adjustments have achieved any sense of maturity or permanence. There are major uncertainties looming. Foremost among these is the scheduled implementation of the Federal Energy Regulatory Commission's ("FERC") Locational Installed Capacity ("LICAP") rules in 2005. These rules could add significantly to the cost of electricity but more importantly will lead to a great deal of uncertainty and a significant risk premium during a lengthy implementation period. Similarly, WMECO believes that the future implementation of nodal pricing for load, or Special Case Nodal Pricing ("SCNP"), may also carry a risk premium.[1] Further, the imposition of congestion costs creates pricing uncertainty going forward.

On the market side, there has been considerable volatility in natural gas prices in the past year. Natural gas prices are a primary determinant of electricity prices in New England. While no one can predict if natural gas prices will become less volatile in the future, it would be prudent to avoid major changes until a better determination can be made.

In WMECO's view, it would be highly preferable for the Department to maintain its current, time-tested procurement procedures as the Commonwealth and the region

[1] FERC's December 21, 2004 Order (Docket ER02-2330-029) approved eligibility criteria for SCNP which, initially, should have minimal impact on zonal energy prices. However, it is expected that over time, the eligibility criteria will broaden allowing more loads located at lower priced nodes to receive nodal pricing. This will result in higher zonal energy prices for loads, such as default service, that receive zonal pricing.

attempt to work through the state of market flux resulting, at least in part, from LICAP, nodal pricing, congestion and natural gas price volatility.

In sum, WMECO recommends that the Department reiterate that the policy arrived at in D.T.E. 02-40-B remains an appropriate balance for smaller customers' default service procurement.

III. WMECO'S RESPONSE TO THE DEPARTMENT'S QUESTIONS

The Department states that it seeks comments to its questions on (1) the advantages and disadvantages of increasing the number of default service solicitations; (2) the advantages and disadvantages of changing the length of the default service procurement term; and (3) the advantages and disadvantages of a statewide procurement process for default service load. Order, pp. 4-5. WMECO's responses are as follows:

Question 1. Would smaller customers be better served if power supply for default service is procured using a portfolio of more than two solicitations? Please discuss the advantages and disadvantages of increasing the number of solicitations used to procure default service supply.

Response: As stated above, the procurement policy for default service supply ordered by the Department in April 2003 strikes a reasonable balance. A single solicitation in which 100 percent of supply is procured at one time exposes smaller customers to a considerable amount of price volatility. On the other hand, conducting numerous solicitations in order to blend prices serves to insulate customers unduly from market-based pricing, and is resource-intensive. It is obvious that a balance must be struck and the Department arrived at an appropriate one in requiring a blended rate based on laddered solicitations six months apart.

While the current procedure is appropriate, other procedures could be considered. For example, the Department could consider whether one-third of the needed supply should be procured every six months for an 18-month period. This would have the effect of further reducing price volatility for customers. A further expansion along these lines would be a procedure that involved a procurement every six months and specified a particular percentage of load to be procured for a one-to-two year period. However, WMECO is not recommending these changes at this time. As described above, the energy market at present is very uncertain. This uncertainty increases as the term of the contract increases. If suppliers are required to bid for a longer term an additional risk premium almost certainly will be added. The result, then, is upward pressure on the prices customers will have to pay.

In its Request for Comments, the Department raises the possibility of soliciting one-third of supply every year for a three-year period (p. 4). It is not clear to WMECO if rates would change under this proposal at least every six months and, therefore, meet the requirements of G.L. c. 164, § 1B(d). Further, in WMECO's view there is no particular need to insert a greater risk premium into default service procurement. The balance between price volatility and market pricing inherent in the current system is appropriate and the system is working as intended.

WMECO recommends against solicitations more frequent than every six months. More frequent solicitations were fully considered by the Department in D.T.E. 02-40-B. In that case, the Division of Energy Resources ("DOER") suggested a staggered approach in which each distribution company would conduct quarterly competitive solicitations to procure one-eighth of its default service supply. D.T.E. 02-40-B, p. 41. A broad coalition of parties, including the Attorney General, the Competitive Retail Suppliers, Fitchburg Gas and Electric Light Company, NSTAR and WMECO, opposed DOER's proposal. These parties, and others, argued that longer-term and staggered solicitations are "unduly complicated, unnecessarily burdensome and has the potential to increase default service rates by eliminating purchasing economies…." *Id.*, p. 42. For companies with relatively smaller default service loads, such as WMECO, splitting the load into many segments may decrease supplier interest in any one solicitation and, thus, increase supply costs. *Id.*, p. 42.[2] A number of parties also commented in D.T.E. 02-40-B that increasing the number of solicitations would insulate default service prices from market conditions, to the detriment of the competitive market. *Id.*, p. 42.

WMECO believes the argument against frequent default service solicitations is as telling now as it was when the issue was last investigated in D.T.E. 02-40-B. Given the Department's goals of price stability and market-based pricing for smaller customers, holding laddered default service solicitations twice a year strikes the appropriate balance.

Question 2. Would smaller customers be better served if power supply for default service was procured for a term longer than twelve months? Please discuss the advantages and disadvantages of using supply terms greater than twelve months. In particular, please discuss

(a) whether longer contract terms are likely to produce lower prices,
(b) how such an approach would affect price certainty and market efficiency, and
(c) how such an approach could be tailored to accommodate customer migration to competitive supply.

Response: (a) The question as WMECO understands it is whether a default service contract for a term longer than twelve months is likely to produce savings for customers in the form of lower rates compared to several shorter term contracts. In order to answer

[2] This is a concern even when default service absorbs the additional load associated with standard offer customers.

that question definitively one would have to be able to predict market movements. WMECO does not believe anyone can truly predict how the energy markets will move in the future. Clearly, if a longer term contract is entered into and market prices then increase to an unexpected extent, customers will be better off price-wise compared to a series of short-term contracts. Conversely, if a long-term contract is signed and market prices decrease to an unexpected extent, then customers would have been better off price-wise with shorter term contracts. WMECO has experienced both sets of results in its year-long standard offer procurements. Sometimes a one-year contact ends up being to the customer's benefit (compared to a series of shorter contracts); sometimes it does not.

While acknowledging that no one can truly predict market movements in advance, WMECO's does know that uncertainties exist in the market now that undoubtedly will lead to risk premiums. These risk premiums weigh against significantly increasing the procurement term. For example, as previously indicated, given the uncertainty over LICAP, any long-term contract entered into now might carry a LICAP-related risk premium that would not be present at such time in the future when the LICAP rules are fully implemented and resolved. Nodal pricing, congestion issues and the volatility of the natural gas market may also suggest that it is not to customers' benefit to enter into long-term contracts at present.

(b) In terms of price certainty and market efficiency, there is no question that a longer term default service procurement would decrease price volatility and increase price certainty. If the Department concludes that the balance between price stability and market-based pricing needs to be shifted to ensure more price stability, then longer-term procurements are an option. Longer-term procurements do not mean price savings to customers, but simply more price predictability.

(c) WMECO is aware of the debate at the Department in D.T.E. 02-40 concerning whether shorter-term default service rates are more conducive to customers leaving regulated service to go to the competitive market or whether longer-term rate are better at facilitating customer migration.[3] WMECO is uncertain of the 'right' answer to this question or if there is one right answer. WMECO can understand that if a customer is given a default service rate that will not change for some lengthy period of time, such a procedure might facilitate a competitive supplier's efforts to sign the customer to a contract that could beat that rate. If the default service rate were to change frequently, the competitive supplier might have a harder time convincing the customer that the competitive price is advantageous. On the other hand, a customer may not want to be exposed to frequent default service rate changes and opt for price stability from a competitive supplier.

Question 3. Would smaller customers be better served if power supply for default service was procured on a statewide basis? Please discuss the advantages and disadvantages of using a statewide approach to default service procurement.

Response: WMECO does not believe that either smaller or larger customers would be better served by statewide default service procurement. WMECO believes that customers are well-served by the current procurement system and that there are some significant downsides to a statewide approach, apart from the likelihood that a statewide solicitation would require legislative action.[4]

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[3] For larger customers, the Department determined that rates that change more frequently are most conducive to migration to competitive supply. *See, e.g.*, D.T.E. 02-40-B, pp. 38-40.

[4] As cited above, G.L. c. 164, § 1b(d), requires distribution companies to conduct default service procurements.

While superficially it might appear more efficient to procure default service on a statewide basis, WMECO doubts that such a process is as beneficial as the one currently in place. First, although the solicitation is in some sense statewide, bids would also have to be distribution-company specific. Otherwise, distribution company customers in one area would be saddled with costs attributable solely to pricing characteristics particular to other distribution companies' customers. For example, default service would have to be bid separately for WMECO's customers. If not, WMECO's customers presumably would be subsidizing the higher costs needed to serve customers in other sections of the Commonwealth, such as in the Northeast Massachusetts ("NEMA") pricing zones. WMECO would take strong exception to any system that forces its customers to pay higher prices due to conditions inherent in other distribution companies' service territories. But, if the solicitation is distribution-company specific, as it must be, the advantage of a 'statewide' solicitation is dubious.

Second, each of the Massachusetts distribution companies has the in-house expertise to analyze energy markets, craft default service solicitations and contracts, answer bidders' questions, evaluate credit risk, provide default service data to bidders, solicit bids and enter into binding agreements. If a statewide approach means that the state would be taking over each of these duties, it would necessitate the creation of an entirely new state infrastructure that would include personnel with all of the needed skills. WMECO sees little advantage in the state creating a bureaucracy to duplicate functions that are performed perfectly well by the regulated companies.[5]

[5] In the alternative, the state would have to engage a consulting firm or firms to run the solicitation, eliminating the new state infrastructure but resulting to the same duplication of functions.

Third, a statewide solicitation also raises questions concerning the entity enforcing the contract. WMECO, as part of the Northeast Utilities ("NU") system, monitors each contract for the duration of its term to ensure the creditworthiness of the supplier and WMECO will take action to enforce the terms of the contract in the event of a supplier breach. Unfortunately, WMECO has had an instance in which a supplier threatened to cease performance and brought lawsuits against WMECO for alleged breaches of contract when WMECO took steps to protect its customers. While to date WMECO has defended all such lawsuits successfully, it raises the question of the identity of the party that would provide the same services in the event of a solicitation by the state.

Fourth, WMECO believes that the current solicitation process in which each company is on its own procurement schedule limits the opportunity for suppliers to game the system. WMECO further believes that holding all solicitations at once provides more of an opportunity for such gaming, and the higher customer prices that gaming may lead to.

There may be other variants to the statewide solicitation model, but WMECO does not believe they fare any better. For example, there could be a statewide solicitation but each individual distribution company could be required to sign a contract with the winning bidder(s). WMECO has significant concerns with this model. The major issue is that if WMECO is going to assume liability under the contract it believes it should be the party determining the contract language and, particularly, the credit terms. WMECO (and the other NU system companies) has been successful in its efforts to limit credit exposure through the implementation of unilaterally favorable credit terms in default service contracts. These terms uniquely facilitate a high degree of credit security without increased costs to WMECO. A solicitation that imposes a contract enabling bilateral credit recourse could cause WMECO to increase its debt levels and lead to additional costs to WMECO and its customers. In sum, credit provisions are a significant issue in default service contracts and any change required by a statewide contract could have negative implications for WMECO and its customers.

A statewide solicitation requiring a uniform contract presents other issues. New Jersey, a state similar to Massachusetts in that it has several major distribution companies, uses a uniform contract at the conclusion of its auction process, but WMECO's understanding is that such a contact was arrived at only after a long series of hearings at the public utility commission. The time and expense of developing a standard contract, and the needed periodic updates to such a contract, which may in the end not be satisfactory to the distribution companies, is another reason not to pursue a statewide solicitation.

WMECO recognizes that Maine holds a statewide solicitation. According to the Maine Public Service Commission ("MPUC"), the first two solicitations met with "mixed results."[6] It is not clear that the MPUC has the same goals as the Department for default service or that Maine has fully resolved the problems identified with statewide solicitations.[7] Certainly, the energy price increases that Maine customers are

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[6] "Standard Offer Study and Recommendations Regarding Service after March 1, 2005", issued by the Maine Public Utilities Commission, December 1, 2002 ("Maine Report"), p. 8.

[7] For example, distribution companies backstop the solicitation. If the public utility commission is dissatisfied with the results, standard offer service is provided by the distribution company through wholesale contracts. Such a process leaves the distribution company with significant responsibilities. Maine Report, p. 8. In addition, Maine restricts the ability of

experiencing, reportedly in the range of 30 percent, does not suggest that the solicitation meets the Department's concerns regarding rate volatility. In addition, Maine is a much smaller state, with only one major distribution company, Central Maine Power Company ("CMP"). CMP is required to sign the contract resulting from the solicitation but CMP, apparently, simultaneously attempts to disclaim responsibility under the contract. It is not clear how effective such a disclaimer is. Thus, responsibility in the event of a lawsuit remains untested.[8]

Question 4. Would smaller customers be better served if power supply for default service was procured using an auction process (e.g., descending clock) rather than through requests for proposals? Please discuss the advantages and disadvantages of using an auction process to procure default service. In particular, please discuss whether using an auction is likely to produce lower default service prices.

Response: As indicated above, WMECO believes the current default service procurement system works as intended. WMECO is not aware of any analyses or studies which demonstrate that an auction process would achieve superior results for customers compared to the existing Massachusetts procurement process.

WMECO has limited familiarity with the auction process held in New Jersey. As far as WMECO is aware, that process has led to acceptable results, although it appears that the process itself is rather complicated. For example, in Massachusetts the distribution companies run the solicitations. There are no, or very limited outside costs,

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distribution company affiliates to bid, contrary to Massachusetts law. Maine Report, p. 8; G.L. c. 164, §1B(d).

[8] In practice, WMECO is concerned that as a signatory to any contract it would be sued as a perceived 'deep pocket' and would have to defend such a lawsuit even if it had not negotiated the contract, regardless of any attempt to disclaim responsibility.

involved in these procurements.[9] In New Jersey, however, two major consulting firms are employed in the auction process. One firm is hired by the utilities to conduct the solicitation. Another firm is hired by the state to oversee the process. WMECO has no idea how expensive it is to hire (and oversee) these firms. These costs are presumably borne by the customers, however, and this is an category of costs avoided by customers under the current Massachusetts procurement method.

Further, an auction process appears to have many of the same disadvantages of a statewide procurement, as discussed above in the response to Question 4. For example, although the auction may be done in some sense statewide, it nonetheless has to result in prices specific to each distribution company's service territory. In addition, the concerns regarding cost, enforcement and credit set forth in the response to Question 4 also apply equally to a statewide auction. Further, it is unclear to WMECO whether a different level of market interest in needed to make an auction successful as compared to a solicitation. It is possible that there would not be sufficient interest in an auction for a smaller distribution company to achieve results comparable to that of a solicitation.

Question 5. Although the term "Default Service" is statutory, G.L. c. 164, § 1, it has confused some customers because of its unintended suggestion of nonfeasance in performing a legal or contractual obligation. Is there some better or more descriptive term that ought to be used by the distribution companies on and after March 2005?

Response: WMECO agrees that the term default service may confuse some customers and lead others to believe they are being relegated to second-class status. In WMECO's opinion, there is nothing in G.L. c. 164 that precludes the Department and distribution companies from referring to default service by an alternative name.

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[9] Because WMECO has an affiliate that sometimes bids in its solicitations, an individual is routinely employed as an independent third-party to oversee WMECO's solicitations. No other distribution company hires such a third party, to WMECO's knowledge.

WMECO believes it would be reasonable to refer to default service as ‘Basic Service’ or ‘Basic Electric Service’ in its interactions with customers. Such terms are neutral and should not carry any of the negative connotations of the term ‘default service.’

IV. CONCLUSION

WMECO respectfully requests that the Department consider WMECO’s comments and looks forward to participating further in the Department’s consideration of default service procurement rules.